MEMORANDUM OF LAW

DATE: September 23, 1993

TO: Jack McGrory, City Manager

FROM: City Attorney

SUBJECT: Legal Authority and Potential Liability for City's Entrepreneurship Program

This Memorandum of Law contains a summary of legal issues raised by the City's Entrepreneurship Program. The Entrepreneurship Program comprises many projects, which range from existing projects such as the City Store, to newly established projects such as City Ventures, to proposed projects such as the Centre for Organization Effectiveness. These projects not only share common legal issues, but they also each pose distinct legal issues.

This memorandum is intended to highlight the major legal issues the City Attorney has identified and researched to date. We anticipate that new or different legal issues may be raised by different entrepreneurial projects undertaken in the future. We will research and analyze the legal issues in future projects as they arise.

With the goal of providing sound legal advice, the City Attorney has devoted many resources to researching the issues in this memorandum. The City Attorney wishes to take this opportunity to acknowledge the research and writing assistance of the following current and former legal interns: Lydia Brashear, Anthony Kidd, Christopher Morris, and Kristen Spieler.

FACTUAL BACKGROUND

To understand the legal issues, it is necessary to recite briefly some of the projects undertaken or proposed to be undertaken in the name of the City's entrepreneurship program. The City Store was the first pilot project undertaken. When it was first authorized by City Council Resolution No. R-278672, on September 23, 1991, it was designed to sell primarily surplus City property (e.g., used City parking meters). The City entered a contract with independent retail managers to operate the Store. The City now has three (3) sites: one in the City Administration Building; the second at Horton Plaza; the third at Seaport

Village. We understand a fourth is being contemplated for the downtown library. Since its inception, the City Store has branched out and sells more than surplus City property. It sells goods that are made and purchased expressly for resale at the City Store. Most, if not all of the goods, sold at the Store bear the City seal or other logos or marks tying the item to the City.

In March 1993, the City Council authorized another pilot project to obtain private sponsors to maintain or enhance existing service levels in the City's parks (Resolution No. R-281549). If successful, the City Manager proposes expanding the program to cover sponsorships of services in other City departments. For purposes of the pilot program, the City Council waived its policies on product endorsement (Council Policy 000-23) and increased the monetary amount of donations the City Manager is authorized to receive without Council approval (Council Policy No. 100-2).

In addition to the above-described pilot programs that have been formally authorized by the City Council, the City Manager has established the Centre for Organization Effectiveness ("Centre") (separate and distinct from the Organizational Effectiveness Program, which operates under the City's Financial Management Department). We understand that the City Manager will be seeking formal Council approval of the Centre at the Council meeting scheduled for September 27, 1993. It is anticipated that the Centre will "sell" the City's Diversity Program (and perhaps the City's Management Academy) both to other public entities and to private companies. In fact, a brochure advertising the program has already or will soon be mailed to potential "customers." The Centre may eventually also serve as a broker for hiring consultants and finding customers for other services such as management training, etc.

With the encouragement of the City Manager, individual departments are coming up with various entrepreneurial projects, which are in various stages of development and review. These proposals range from rental of the police video editing facilities and equipment for use in off-hours by a nonprofit corporation, to sale of police raw video footage (stock shots), to publishing a book on the City's Diversity Program.

As described by the City Manager, the City's Entrepreneurial Program and projects undertaken pursuant to its name are or will be designed in large part to raise revenue for the City other than by the means of taxation and fees. Underlying the Entrepreneurial Program is the City Manager's philosophy that the City should be run like a private enterprise.

As it approaches this goal, the City may be faced with legal dilemmas that it does not now have to face as a traditional public entity (for example, potential erosion, or loss of certain immunities). Also, because entrepreneurship is such a new idea for cities, the authority for some of the projects is vague and legal guidance in the form of case law, statutes, or ordinances is minimal to non-existent.

The framework for discussion of legal issues in this memorandum is as follows: First, does the City have authority to operate entrepreneurship programs for the sole or primary purpose of raising revenues? That is, what constitutional, charter, statutory or municipal ordinance authority exists to support the program and, if that authority is successfully challenged, what are the legal consequences? Second, what potential liability arises from operating entrepreneurship programs? Each of these legal issues and their subissues are discussed briefly below:

LEGAL ANALYSIS

I. What is the City's Authority to Operate An Entrepreneurial Program?

A. Constitutional Authority

As a general rule, charter or "home rule" cities in California enjoy very broad legislative powers. In a particularly thorough opinion issued by the California Supreme Court last winter, the Court summarized the evolution of "home rule" law in California. Johnson v. Bradley, 4 Cal. 4th 389, 394-400 (1992). Article XI, Section 5(a) of the California Constitution grants those cities governed by charters to "make and enforce all ordinances and regulations in respect to municipal affairs," subject only to the limitations and restrictions of their own charters and, in respect to non-municipal or statewide affairs, subject only to general state laws. A substantial body of law commonly known as the "municipal affairs" doctrine has developed over the years to flesh out the meaning of this constitutional provision.

Our research revealed no California cases challenging the lawfulness of an entrepreneurship program on the grounds that there was no constitutional authority for the program. Dictum in some older cases suggest, however, that absent express legislative authority, a city, even a charter city, has no authority to engage in any independent business enterprise or occupation that is usually pursued by private individuals. See Ravettino v. City of San Diego, 70 Cal. App. 2d 37, 44 (1945).

In this case, The City of San Diego attempted to avoid tort liability for actions by the Harbor Commission, which was then under the City's jurisdiction. Under the facts of that case, the

Harbor Commission had rented out a crane to private companies when the crane was not being used for Harbor business. While being rented out, the crane caused severe injuries to Ravettino, an employee of the company. Ravettino sued the City, and the City lost. The case is interesting because the City asserted as a defense the claim the Harbor Commission's rental of the crane to private companies was ultra vires, that is beyond their authority, and therefore the City should not be held liable. Although the court agreed in dictum that the crane's rental may have been ultra vires, the court clearly stated that the City could not avoid liability by asserting the ultra vires doctrine as a defense. To avoid application of the ultra vires doctrine, the court found a municipal purpose was served by the renting out of the crane. Id. at 47-48.

Another California case construed the constitutional term "municipal purpose" broadly to permit the City of Berkeley to establish and operate a municipal market. Bank v. Bell, 62 Cal. App. 320, 334 (1923). The Bank court examined the historical purpose of the municipal affairs doctrine and found that:

> For the purpose of getting at the true significance of these words, there is no brighter light to be shed upon them, than is disclosed by a consideration of the reasons which moved the legislature to propose the amendment and the people to adopt it. What was the evil to be remedied? What was the good to be gained by this amendment? The answer is common, every-day history. It was to prevent existing provisions of charters from being frittered away by general laws. It was to enable municipalities to conduct their own business and control their own affairs, to the fullest possible extent, in their own way. It was enacted upon the principle that the municipality itself knew better what it wanted and needed than the state at large, and to give that municipality the exclusive privilege and right to enact direct legislation which would carry out and satisfy its wants and needs.

Bank v. Bell, 62 Cal. App. at 325, (citing Fragley v. Phelan, 126 Cal. 383, 387 (1899)).

Despite specifically upholding a city-owned and operated market, the court's dictum in the Bank case suggests that activities undertaken solely for revenue raising purposes may not be a legitimate municipal purpose. Id. at 330. The Bank court noted that courts generally defer to legislative determination of "public" or "municipal" purpose. Id. at 333.

The fact that there are no cases challenging the authority of entrepreneurship programs per se is not surprising in light of the newness of the programs. Despite the dictum in the Ravettino case and in light of the courts' tendency to construe "municipal purpose" broadly, as in the Bank case, we think a court would probably find the City has authority under Article XI, Section 5 of the California Constitution to operate its entrepreneurship program.

B. Charter Authority

Article 1, Section 2 of the San Diego City Charter ("Charter") grants the City the broadest possible powers necessary to exercise its "municipal affairs," subject only to the limitations set forth in the Charter itself and in the state and federal constitutions. Except those powers reserved by the people of San Diego, the City's legislative power is vested in the City Council. Article III, Section 11 of the City Charter. Not surprisingly, since entrepreneurship programs were not contemplated in the early 1930's when this City's Charter was adopted, the power to establish and run an entrepreneurship program is not expressly authorized in the Charter. Neither is there any express prohibition. We point out, however, that elements of the program will be subject to the same Charter limitations as are other more traditional programs the City undertakes. For example, if the entrepreneurship program requires purchase of supplies or equipment, it would have to follow the rules set forth in Charter section 35, as interpreted by the City Council in the San Diego Municipal Code.

Our research revealed no case challenging a City's authority under its charter to establish or operate an entrepreneurship program. However, a California appellate court specifically upheld a city's authority under its charter to establish and operate a municipal market. Bank v. Bell, 62 Cal. App. 320 (1923). In this case, the City of Berkeley established and operated a food market. The court found that the City of Berkeley, "under the provisions of its charter, has plenary power to acquire, establish, maintain, equip, own and operate a

municipal market, and also, acting through its council, power to take such legislative action as it may deem necessary" to operate the store.

The Charter also contains a very broad grant of legislative power as in the Berkeley City Charter. Therefore, in light of this very broad grant of Charter authority, we believe the City Council has the authority to exercise its legislative power to establish and operate an entrepreneurship program.F

To the extent that City Attorney Memorandum of Law issued on March 17, 1989, concludes that the San Diego City Charter does not contain authority to allow certain types of advertising, it is overruled.

C. Statutory Authority

Because The City of San Diego operates under a charter, as discussed above, it is not necessary for the City to rely solely on California statutes for authority to establish or operate an entrepreneurship program. We note, however, that counties have obtained express statutory authority to operate certain aspects of their entrepreneurship programs.F

Critically, although counties are permitted to adopt "home rule" charters under the California Constitution, the scope of counties' charter authority is much narrower than that of cities. Compare California Constitution Article XI, Section 4 (counties) and California Constitution Article XI, Section 5 (cities). For example, counties have sought and obtained express statutory authority for sponsorship programs and to permit advertising solely for the purpose of raising revenue. (See Government Code sections 26109 and 26110.) Government Code section 26109 essentially permits counties, not cities, to provide for and regulate the sale of advertising space on county-owned real and personal property for the sole purpose of raising revenue for the county. Government Code section 26110 requires counties to develop and adopt detailed marketing plans for any sponsorship programs they undertake.

D. San Diego Municipal Code Authority

The San Diego Municipal Code ("Code") is a compilation and codification of the City's laws as adopted by the City Council in the form of ordinances. Among other things, the ordinances represent how the City Council interprets the Charter and how it chooses to exercise its legislative authority granted to it by the Charter.

Currently, there are no express provisions in the Code establishing an entrepreneurship program or directing the City Manager to operate one. It is our understanding that the City Manager will soon bring forward to the City Council proposed

changes and additions to the Code which will be required to operate certain aspects of the entrepreneurship program.

Until such time as the Code is changed, the City Manager is operating the entrepreneurship program under pilot projects which are individually authorized by Council resolution. The City Store operates under Resolution No. R-278672, adopted on September 23, 1991. The City's pilot public/private partnership (sponsorship) program, which currently focuses on the Park and Recreation Department, operates under Resolution No. R-281549, adopted on March 1, 1993. It is our understanding that the City Manager will soon be seeking the Council's authority to operate an expanded version of the public/private partnership program, entitled "City Ventures." We also understand the City Manager will be seeking authority at the September 27, 1993, Council meeting to establish and operate the "Centre for Organization Effectiveness," which will among other things "sell" the City's Management Academy and Diversity Program to persons both in the public and private sector. There may be more entrepreneurship programs developing in the City, about which the City Attorney is currently unaware, which will require Council authorization to go forward. The City Attorney relies on the City Manager to bring them to Council for approval and authorization at the appropriate time.

E. City and Public Official Liability in the Event of Legal Challenge to Authority

As shown above, the City probably has authority under the State Constitution and its own Charter to undertake entrepreneurship programs for the sole or primary purpose of raising revenue. However, if a legal challenge is mounted attacking the underlying authority of the City to undertake such programs, the most likely remedy would be injunctive relief, not damages. See, e.g., Indiana State Fair Board v. Hockey Corp. of Amer., 333 N.E.2d 104 (Ind. Ct. App.) (1975). In this case, Hockey Corporation sued the Indiana State Fair Board for operating a public ice skating rink and retail shop at a profit. The Indiana court granted injunction relief but denied damages. Seven years later the decision was vacated by the Indiana Supreme Court on the grounds that the Fair Board's operation of the skating rink was not ultra vires under the applicable state law. Indiana State Fair Board v. Hockey Corp., 429 N.E. 2d 1121 (Ind. Sup. Ct.) (1982).

If the City's authority is challenged, the City Council or Manager's actions may also be challenged as being "ultra vires," or outside their authority. Id. If so, the plaintiff may seek to hold the city officials personally and individually liable for

damages. This action would likely take the form of a taxpayer suit alleging improper expenditure of public funds. In California, a city taxpayer may prevent the misapplication of public funds before it occurs by bringing an action for declaratory and injunctive relief under California Civil Procedure section 526(a). In addition, a taxpayer can sue the public officials responsible for misapplication of public funds in order to recover the funds on behalf of the City. See, e.g., Fox v. City of Pasadena, 78 F.2d 948 (1935).

Until recently, the rule set forth in Mines v. Del Valle, 201 Cal. 273 (1927), held public officials strictly liable for any expenditures of public funds later determined to be unauthorized. In 1976, however, the California Supreme Court in Stanson v. Mott, 17 Cal. 3d 206 (1976), expressly overruled Mines, and held that a "public official who, in good faith . . . authorizes the improper expenditure of public funds is personally liable to repay such funds only if he fails to exercise 'due care'." (Emphasis added.) Mott was the Director of State Department Parks and Recreation, who authorized the expenditure of public funds to promote passage of a park bond issue. Although the department had statutory authority to disseminate "information" to the public relating to the bond election, the court construed the material to be a form of campaign literature and therefore an illegal expenditure of public funds. Rejecting the statement in Mines that "[t]he powers of municipal officers are well defined," the Mott court recognized that often the propriety of expenditures turns on an evaluation of subtleties. Mott, 17 Cal. 3d at 223 (citing Mines at 288-89). Accordingly, in order to hold a public official personally liable a complainant must allege and prove a public official's failure to exercise due care in authorizing the challenged expenditures. Id.

In the present case, a disgruntled taxpayer may claim that a particular entrepreneurial activity undertaken by the City provides no public purpose and therefore is an unlawful activity. The claim to enjoin any further spending would be brought under California Civil Procedure section 526(a). In this form of taxpayer lawsuit challenging an entrepreneurship project, a court's determination of the propriety of the City's expenditures will likely turn upon the subtleties of the phrase "public purpose." Public purpose evades absolute definition because it changes with changing conditions of society. While it appears the modern trend is to expand and liberally construe the phrase, "[t]he courts as a rule have attempted no judicial definition of a public purpose, but have left each case to be determined by its

own peculiar circumstances." 56 Am. Jur.2d Municipal Corporations Section 582 (1971).

Illustrating this proposition is the case of Pipes v. Hilderbrand, 110 Cal. App. 2d 645 (1952), in which a mandamus proceeding was brought against the Commissioner of Finance for the City of Fresno to compel payment on a contract for the construction of airport hangers. The Commissioner refused to issue the payment because he questioned whether construction of airport hangers to be leased to a private company for aircraft modification and manufacturing served a public purpose. Issuing the writ, the court stated that

> the question as to whether the performance of an act or accomplishment of a specific purpose constitutes a public purpose . . . rests in the judgment of the city council, and the judicial branch will not assume to substitute its judgment for that of the governing body unless the latter's exercise of judgment or discretion is shown to have been unquestionably abused.

Id. at 649 (citing City of Oakland v. Williams, 206 Cal. 315 (1929)).

Although the court in Pipes appears to defer to the city council's judgment of what constitutes a public purpose, the activity challenged in that case related to the acquisition and maintenance of airports, which had been authorized by the state to be a municipal responsibility. Therefore, because the construction of hangers contributed to the improvement of the airport, it was not a far stretch to find a public purpose. Similarly, the challenged expenditures in the City of Oakland case, which involved the construction and leasing of warehouses on the harbor, was considered a public purpose largely because the construction was viewed as part of the city's comprehensive harbor development plan.

In light of the Pipes and City of Oakland cases, it would be beneficial for the City's entrepreneurship program if it can be said to contribute to the public good in a way other than simply increasing revenues. The City Council should be encouraged to make legislative findings to that effect. If an entrepreneurship project is challenged, a court will then, hopefully, defer to the City Council's determination of public purpose.

Where it occurs that a court deems the City's

entrepreneurial activity to serve no public purpose, the result will likely be twofold. First, the taxpayer will likely succeed in obtaining an injunction against future public funding of the activity. See Indiana State Fair Board v. Hockey Corp. of Amer., 333 N.E.2d 104 (Ind. Ct. App.)(1975). Second, given the current state of confusion surrounding what constitutes a public purpose, City Councilmembers and the City Manager will probably be protected from liability for reimbursement so long as they act in good faith and with due care in authorizing the expenditures. Stanson v. Mott, 17 Cal. 3d 206 (1976).

In determining whether a public official has acted with due care, Mott held that a court may consider whether the impropriety was obvious, whether the official was alerted to the possible invalidity of the expenditure, or whether the official relied on legal advice or on the presumed validity of an existing legislative enactment or judicial decision in making the expenditure. Id. at 227. How far toward the poles the enterprise falls on the continuum of public/private purpose will likely answer these questions. Only the extremes are clear enough to either warn or to be relied upon.

In conclusion, as the City moves further from what are traditional governmental functions into the realm of municipal entrepreneurship, the City must be prepared to deal with several problem areas. One involves taxpayer lawsuits that seek to enjoin future spending for these programs by challenging the "public purpose" of the activity. Absent express authorization by the State, the City's declaration of public purpose will best withstand this challenge where it can show that the activity improves the general well-being of its citizenry in some non-fiscal way. A second problem area relates to taxpayer suits directed at the City's public officials in an attempt to regain the misappropriated funds. Here, the City should take action consistent with case law to remain under the protective umbrella of Mott.

II. Potential Prohibitions and Potential Liability Resulting from Entrepreneurship Programs

Assuming a court finds that the City has legal authority to operate an entrepreneurship program, a court would next examine potential prohibitions, obligations, and liabilities. These matters are treated in this section of the memorandum.

A. State Sales Taxes

Cities and counties are liable for state-imposed sales taxes on any tangible personal property they sell, if the sale is otherwise taxable, just as is any other entity. California Revenue and Taxation Code section 693-6014; People v. County of

Imperial, 76 Cal. App. 2d 572 (1946). The City already has a Tax Identification Number and pays sales taxes to the State for items sold at the City Store. Whether the City will be liable for sales tax on the sales of the Diversity Program through the Centre will depend on what is the primary form of the sale. If the focus is on the training and the transfer of written documents is merely incidental for the training, then the sale of the program will not be taxable. Cal. Rev. Tax Code section 6006, 6015; 18 Cal. Code of Regs. section 1501. See, e.g., Institute in Basic Youth Conflicts, Inc. v. State Bd. of Equalization, 166 Cal. App. 3d 1093, 1097, n.1 (1985). If, however, the object of the sale is to transfer the training documents to the consumer, not the training program itself, the transfer or sale of the document will be subject to the sales tax. 18 Cal. Code of Regs. Section 1501.

B. Federal Income Taxes

As a general rule, state governments and their political subdivisions are immune from federal income tax liability when undertaking traditional government functions in the capacity of a governmental entity. Section 115(1) of the Internal Revenue Code provides that gross income does not include income accruing to a state, or a political subdivision thereof, derived from the exercise of any essential governmental function. 26 U.S.C. section 115.

In an unusual legal development, while court cases establish a clear trend to narrow the scope of the state and municipal immunity granted by U.S.C. section 115, the Internal Revenue Service, the federal agency charged with administering and enforcing the income tax laws, has been enlarging that immunity. Both federal case law and Internal Revenue Service rulings are discussed below.

1. Federal Case Law

Indicative of the courts' trend to narrowly apply the immunities is the United States Supreme Court's holding in Massachusetts v. United States, 435 U.S. 444 (1978). There the Supreme Court summarized and adopted the rationale underlying this trend. In that case, the state of Massachusetts challenged a federal tax imposed on all civil aircraft. Specifically, the state objected to the tax as applied to a helicopter owned and operated by the commonwealth. Id. at 452. In upholding the imposition of the tax, the Court stated:

> In tacit, and at times explicit, recognition of these considerations, decisions of the Court either have declined to enlarge the scope of

> state immunity or have in fact restricted its reach . . . . The purpose of the implied constitutional restriction on the national taxing power is not to give an advantage to the States by enabling them to engage employees at a lower charge than those paid by private entities, . . . but rather is solely to protect the States from undue interference with their traditional governmental functions.

Massachusetts, 435 U.S. at 457-459. See also, New York v. United States, 326 U.S. 572 (1946) (tax on water bottled and sold by the state upheld); Allen v. Regents, 304 U.S. 439 (1938) (tax on admissions to state athletic events approved); Helvering v. Powers, 293 U.S. 214 (1934) (tax on the operations of the state railroad upheld); South Carolina v. United States, 199 U.S. 437 (1905) (tax on state run liquor business upheld).

The fact that the tax is collected directly from state treasuries has been held to be inconsequential as it pertains to the validity of the tax itself. In Helvering v. Gerhardt, 304 U.S. 409, 82 L.Ed. 1427 (1938), the Court stated that a guiding principle in deciding intergovernmental immunity is "excluding from the immunity activities thought not to be essential to the preservation of state governments, even though the tax be collected from the state treasury." Id. at 419.

Thus, under federal case law at least, the validity of the tax depends largely on the underlying nature of the activity being undertaken. Furthermore, in New York, the majority assumed that a nondiscriminatory tax may be applied to a state's business activity where the recognition of immunity would

> accomplish a withdrawal from the taxing power of the nation a subject of taxation of a nature which has been traditionally within that power from the beginning. Its exercise . . . by a nondiscriminatory tax, does not curtail the business of the state government more than it does the like business of the citizen.

326 U.S. at 588-589.

Thus, the overwhelming judicial inclination is toward the narrowing of the federal tax immunity granted to state and local governments. While the authorities have cited various reasons

for so doing, it appears the need for federal revenue is the controlling factor. See e.g., Massachusetts, 435 U.S. at 456. Therefore, based solely on the case law, it would appear that at least some of the goods sold at the City Store may not be immune from federal tax. The City's liability to pay federal income tax on the income derived from sale of the Diversity Program is even more unclear. However, as will be discussed below, the Internal Revenue Service itself has taken a much more expansive view of state and municipal immunity from federal taxes.

2. Internal Revenue Service Rulings

The Internal Revenue Service has taken a much broader view of state and political subdivisions' immunity from federal taxes. In so doing, the Internal Revenue Service has either refused to apply the Internal Revenue Code at all to funds accruing directly to governmental bodies, or has taken the opportunity to expand the scope of "essential governmental functions" to encompass the activity at issue.

The Internal Revenue Service has stated its position in both official Revenue Rulings and less formal Private Letter Rulings. Revenue Rulings are official statements of the law handed down directly from the Service. Conversely, while Private Letter Rulings provide guidance and are illustrative of how the Internal Revenue Service views certain issues, they do not have the force of law and cannot be cited as precedent.

a. In most instances, the Internal Revenue Service has refused to apply Title 26 to states and lesser political subdivisions.

In Revenue Ruling 71-131, 1971-1 C.B. 28, the state of Montana had established a Liquor Control Board. The applicable civil code provided that the purpose of the board was to buy, sell, and control the sale of liquor. The code also stated that the board "shall pay into the state treasury, to the credit of the general fund, the receipts from all taxes and licenses collected by it; and also the net proceeds from the operation of state liquor stores." Rev. Rul. 71-131, (1971). The Internal Revenue Service ruled that the income derived from the state liquor stores was not subject to federal tax. Id. See also, Rev. Rul. 71-132, 1971-1 C.B. 29 (holding that liquor stores operated by the state of Oregon were not subject to income tax). But see, Ohio v. Helvering, 292 U.S. 360 (1934) (upholding a tax on a state liquor operation); South Carolina v. United States, 199 U.S. 437 (1905) (upholding tax on state liquor operations).F The Court in Ohio v. Helvering noted that South Carolina v.

U.S., 292 U.S. at 369, was decided before the 18th Amendment to the Constitution (prohibition) was adopted. The Court found that passage of the Eighteenth Amendment had no effect on its ruling to deny tax immunity to the state.

While in Revenue Rulings 71-131, 1971-1 C.B. 28, and 71-132, 1971-1 C.B. 29, the Internal Revenue Service declined to state the reasoning behind the holding, the underlying rationale was set forth in a subsequent Private Letter Ruling. In Private Letter Ruling 91-49-011, Assistant Chief Counsel Alice M. Bennett, stated:

> Section 115 of the Code applies to agencies and instrumentalities that are separate entities, that is, organizations that are not integral parts of the government of a state or political subdivision thereof. Section 115 of the Code, however, does not apply to states directly or to their political subdivisions, such as counties, cities or towns. Generally, the activities conducted directly by states and their political subdivisions are exempt from federal income taxation.

Priv. Ltr. Rul. 91-49-011 (Dec. 6, 1991).

The above quote appears substantially in the same form throughout letter rulings dealing with the scope of state and municipal tax immunity. See e.g., Priv. Ltr. Rul. 92-04-040 (Jan 24, 1992); Priv. Ltr. Rul. 91-40-070 (Oct. 4, 1991); Priv. Ltr. Rul. 88-49-023 (Sept. 9, 1988). Operations by the states and municipalities that have been found to be non-taxable include: a company organized to pool insurance funds, Priv. Ltr. Rul. 92-04-040 (Jan. 24, 1992); a fund established to collect resources to provide educational programs for developmentally handicapped children, Priv. Ltr. Rul. 91-40-070 (Oct. 4, 1991); an entity established to administer a regional solid waste management program, Priv. Ltr. Rul. 91-49-011 (Dec. 6, 1991); and the activities of a state run college, Priv. Ltr. Rul. 88-49-023 (Sept. 9, 1988).

Because the funds and benefits accrued directly to the states or their political subdivision, these activities were deemed to be outside the scope of Section 115. Of significance is the fact that these activities were conducted directly by the political entities themselves. These rulings stand in stark contrast to the cases handed down by the federal courts

previously discussed. In fact, cases dealing with the exact same activity, i.e., liquor sales and college activities, were decided differently.

b. When the Internal Revenue Service has applied Section 115 to state activities, it has adopted an expanded definition of "essential government function"

In Revenue Ruling 77-261, 1977-2 C.B. 45, the Internal Revenue Service was asked to rule on the taxability of a state investment fund. In holding that the proceeds from the fund were not taxable, the Service stated:

> It was pointed out that it may be assumed that Congress did not desire in any way to restrict a state's participation in enterprises that might be useful in carrying out those projects desirable from the standpoint of the state government which, on a broad consideration of the question, may be the function of the sovereign to conduct.

Rev. Rul. 77-261, 1977-2 C.B. 45.

This language has recently been adopted and defined in recent Private Letter Rulings issued by the Internal Revenue Service. In Priv. Ltr. Rul. 90-27-028 (July 6, 1990), the Service was asked to rule on the taxability of a corporation created to assist the city in financing, installing and maintaining public buildings and other public works. The Internal Revenue Service stated,

> the exercise of City's power to provide for such public buildings and improvements constitutes the performance of essential government functions. The sole purpose of the financing activities carried on by the corporation is to assist and support the city in its performance of essential government functions. It is participation by states or political subdivisions in this type of enterprise which Revenue Ruling 77-261 indicated that Congress did not desire to restrict.

Priv. Ltr. Rul. 90-27-028 (July 1990). See also, Priv. Ltr. Rul.

89-44-032 (Nov. 3, 1989) (insurance trust was essential government function), Priv. Ltr. Rul. 90-37-046 (Sept. 14, 1990) (association to pool risk management funds to provide lower rates to municipalities was an essential government function).

Thus, the Internal Revenue Service has adopted a rather expansive approach to the "essential government function" rubric. For all intents and purposes, if the activity is within the power of the City to conduct, then the Internal Revenue Service will not burden its operation with federal taxes.

C. Unfair Advantage: Antitrust, Inverse Condemnation, and Unfair Competition

As the City enters the private market it will inevitably confront private competitors and their claims. A provider of some good or service who finds herself in direct competition with the City, and suffers business losses as a result of that competition, may file a complaint against the City charging any of the following: violation of federal antitrust laws, inverse condemnation, or unfair competition. This section of the memorandum addresses each of these causes of action, assesses their appeal to the plaintiff, and estimates the likelihood of City liability.

1. Antitrust

Any antitrust litigation pitched at the City would have to be brought under federal antitrust laws (Sherman Antitrust Act Section 2, 15 USCA Section 2), because cities are not "persons" who may be sued under state antitrust laws (Cartwright Act, Cal. Bus. & Prof. Code Section 16702) for unlawful restraint of trade. Penn v. City of San Diego, 188 Cal. App. 3d 636 (1987).

Since 1978, however, municipalities have been proper defendants in federal antitrust litigation. Beginning with City of Lafayette, La. v. Louisiana Power & Light Co., La., 435 U.S. 389 (1978) and continuing through Community Communications Co., v. City of Boulder, 455 U.S. 40 (1982), the Supreme Court has refused to extend federal antitrust immunity to municipalities, unless they acted pursuant to clearly articulated state policy to displace competition. In response, Congress passed the Local Government Antitrust Act of 1984 which prohibits the recovery of monetary damages from any local government or its officials "acting in an official capacity." See Sakamoto v. Duty Free Shoppers, Ltd., 764 F.2d 1285, 1288 (9th Cir. 1985). While this statute provides the City immunity from liability, it is immune from suit only where its actions are undertaken pursuant to a clearly articulated and affirmatively expressed state policy. Hoover v. Ronwin, 466 U.S. 558 (1984). The apparent reasoning behind the Court's ruling in the Hoover case is that, when acting

under an express grant of power, the City is carrying out the policy of the state and thus should be protected by state immunity.

Unfortunately, because legislative authorization is time consuming and expensive, it has not kept pace with the needs of modern cities who seek to raise revenues through non-traditional proprietary activities. In short, the city has no independent antitrust immunity from suit and derives its immunity only through the state. (For an argument in favor of absolute municipal immunity with reliance on the political process to correct injurious behavior, see Lopatka, "State Action and Municipal Antitrust Immunity: An Economic Approach," 53 Fordham Law Rev. 23 (1984)).

In conclusion, although the City no longer faces the threat of damages, the City may be forced to defend an antitrust law-suit. Other than injunctive relief, however, this cause of action is a hollow one for a plaintiff seeking money damages. For that reason it will likely be coupled with a more profitable cause of action.

2. Inverse Condemnation

More appealing to potential plaintiff's because of its remedy is an action for inverse condemnation. "Where private property is taken for public use without first paying compensation in a direct condemnation action, the property owner may take the initiative and institute an inverse condemnation action of his own to recover compensation due him." People v. Riccardi, 23 Cal. 2d 390, 400 (1943). This type of proceeding was instituted against a municipality in Hladek v. City of Merced, 69 Cal. App. 3d 585 (1977).

In that case, the city had commenced a "dial-a-ride" transportation system in direct competition with the plaintiff's taxi-cab and dial-a-bus service, causing the plaintiff to lose profits. The court described as "well settled" the proposition that "when a municipal or other public agency engages in competition with a private business and the latter suffers economic harm, the infliction of that harm is not a 'taking' of private property that requires compensation in the constitutional sense." 69 Cal. App. 3d at 588 [citations omitted].

The court acknowledged, however, that as of January 1, 1976, that proposition was unsettled by the change in California's eminent domain law to provide compensation for goodwill business lossesF
Cal. Code Civ. Proc. ' 1263.510(b) defines "goodwill" to consist of "benefits that accrue to a business as a result of its location, reputation for dependability, skill or quality, and any

other circumstances resulting in probable retention of old or acquisition of new patronage."

in certain circumstances.F

Cal. Code Civ. Proc. ' 1263.510(2) provides that the owner must prove that " ┌tσhe loss cannot reasonably be prevented by a relocation of the business or by taking steps and adopting procedures that a reasonably prudent person would take and adopt in preserving the goodwill."

Cal. Code

Civ. Proc. Section 1263.510. As stated in Community Redevelopment Agency, Los Angeles v. Abrams, (decided just two months after the enactment of California Code of Civil Procedure Section 1263.510) "it is quite within the power of the legislature to declare that a damage to that form of property known as business or goodwill of a business shall be compensated . . . ." 15 Cal. 3d 813 (1975) (cert. denied, 429 U.S. 869). Nonetheless, the claim in Abrams was denied because the actual taking was prior to the enactment of the statute and the text of the statute prohibited retroactive application. 15 Cal. 3d at 837; Cal. Code Civ. Proc. Sections 1230.065, 1230.070. The claim in Hladek was denied for the same reason. 69 Cal. App. 3d at 589.

Thus, while it appears that prior to 1976 injury via competition was not a "taking" in the constitutional sense, a competitor injured after 1976 who meets the requirements of California Code of Civil Procedure Section 1263.510 has had a legitimate property interest taken and can bring an inverse condemnation action against the city for compensation.

3. Unfair Competition

California's Unfair Trade Practices Act ("Act") "prohibit ┌sσ unfair, dishonest, deceptive, destructive, fraudulent, and discriminatory practices by which fair and honest competition is destroyed or prevented." Bus. & Prof. Code Sections 17000, 17001. Specifically prohibited activities include price discrimination by locality (Cal. Bus. & Prof. Code Section 17040), discrimination by means of secret rebates (Section 17045), and sales below costs with the intent to injure competitors or destroy competition (Section 17043).

Of greatest concern to the City is the last of these practices because it seems to be the generic allegation made by a competitor who has lost profits due to a government's extension into the private sector. In Hladek for instance, the plaintiff coupled his claim for inverse condemnation with an allegation of unfair competition through sales-below-cost. 69 Cal. App. 3d 585. However, because the challenged activity in that case was a

city-owned transportation system, the activity was considered a "publicly owned public utility" and thus fell under Cal. Bus. & Prof. Code Section 17024, which exempts from the Act operations subject to the jurisdiction of the Public Utilities Commission.F Depending upon the nature of the challenged activity, this exemption may provide relief from claims brought under the Unfair Trade Practices Act.

Accordingly, defendant's demurrer was granted.

Another example of a lawsuit alleging unfair competition by virtue of sales-below-cost is a 1991 Wyoming case in which co-owners of a miniature golf course claimed that a city-owned and leased miniature golf course charged "abnormally low rates" amounting to unfair competition. Kautza v. City of Cody, 812 P.2d 143, 145 (1991). The complaint was dismissed because Wyoming's Unfair Competition Act did not include a city as an entity subject to the statute. Id. at 146. California's Unfair Trade Practices Act, unlike Wyoming's and unlike the Cartwright Act, defines a "person" who may be held liable as including any "municipal or other public corporation." Cal. Bus. & Prof. Code Section 17021. Therefore, there would have been no dismissal in California.

To make out a claim of predatory pricing under California's Act, the elements which must be shown are (1) that the city is selling at less than cost, and (2) that such selling is done for the purpose of injuring its competitors. Cal. Bus. & Prof. Code Section 17043. With regard to the second element, " ┌tσhe state enables a plaintiff to create a presumption of unlawful purpose by introducing evidence of sales below cost plus proof of injury to competitors or competition." William Inglis Etc. v. ITT Continental Banking Co., 668 F.2d 1014, 1049 (1981), (cert. denied, 459 U.S. 825); Cal. Bus. & Prof. Code Section 17071.F However, this presumption may be rebutted by establishing one of the statute's affirmative defenses under Cal. Bus. & Prof. Code ' 17050, including "good faith attempt to meet competition." Since injurious intent may be presumed, what will be dispositive is the ability to show sales below cost.

Section 17026 defines "cost" as including the cost of raw materials, labor, and all overhead expenses of the "producer" (emphasis added). The word "the" appears to imply that costs are personal and, if this is true, the fact that the producer happens to be the city who pays less for raw materials and has lower overhead expenses should not matter in a sales-below-cost lawsuit. Regardless of whether the city is selling below cost in a generic sense (offering a price lower than its competitors), it will not be selling "below costs" for purposes of the statute

until the city's cost of production exceeds the sale price of its product. Given that California governmental entrepreneurial activity is relatively new, we found no cases interpreting the sales-below-cost statute as applied in this context.

D. Products Liability

For purposes of products liability claims when the City engages in commercial business, for example, owning and operating the City Store, it will be treated as any other private party undertaking such activity, for example, a gift store owner. Business profits which parlay into city revenues are an obvious advantage of expanding into the private sector. Less obvious, however, are the disadvantages known as "products liability" and "breach of implied warranty of merchantability." Though familiar to private business owners, they are not the typical causes of action brought against a city. This portion of the memorandum, therefore, reviews the elements of these tort and contract actions and evaluates whether the City's current involvement in providing goods and services make it vulnerable to suit.

1. Strict Liability in Tort

Liability for injury from a defective product will likely be brought on theories of both negligence and strict liability. This section deals only with the latter as it is the most popular basis of liability.

a. Cause of Action

"Persons who manufacture, sell, or otherwise place in the stream of commerce, products which are dangerous or defective may be held liable for personal injuries or property damage resulting from use of such products." 50 Cal. Jur. 3d Products Liability Section 1. This includes retailers. 50 Cal. Jur. 3d Torts Section 38.

Section 402(A) of the Restatement Second of Torts (1965) is essentially the "law" for purposes of products liability. Under that section a plaintiff establishes a prima facie case when she can prove the following:

1. The defendant engaged in the sale or manufacture of the product;
2. The product was expected to reach the consumer without substantial change;
3. The defendant sold the product in a defective condition; and,
4. The product caused physical harm to the consumer'sF

   Although the Restatement refers only to "users o those terms have been broadly defined to extend

human being to whom an injury from the defect is foreseeable. Putersen v. Clay Adams, Inc., 12 C (1970).

person or property.

A products liability suit can be brought for one of two types of defects. One concerns an abnormal or aberrational defect in the "construction" of the product which generally results from a failure of quality control. The other is not aberrational but concerns the defective "design" existing in all of the products of the type at issue. Respectively, these are termed construction defect cases and design defect cases.

A suit based on design defect is more complicated and requires that proof of the third element (defective condition) be shown through a two-prong analysis applying the "consumer contemplation test"F

Under this test a product is defective "if it is dangerous to an extent beyond that which would be contemplated by the ┌foresee-able user who hasσ ordinary knowledge common to the community as to the product's characteristics." Prosser & Keeton on Torts, 5th Edition, p. 698.

and the "danger-utility test."F

Under this test a product is defective as designed if, but only if, the magnitude of the danger outweighs the utility of the product. Raney v. Honeywell, Inc., 540 F.2d 932, 935 (1976).

While the majority of jurisdictions require the plaintiff to prove defective condition through both tests, California takes the more plaintiff-friendly approach announced in Barker v. Lull Engineering Co., 20 Cal. 3d 413 (1978). In that case, the California Supreme Court held that a product is defectively designed if either (1) the plaintiff proves that the product fails the consumer contemplation test, or (2) the plaintiff proves that the product was the proximate cause of the injury and the defendant fails to prove that the product passes the

danger-utility test (emphasis added). Id. In essence, a California plaintiff's prima facie case is simply: "The defendant sold a defective product and I was injured by it."

b. Application to City

There is no question that the City is open to suit arising from a defective product sold by the City Store. The City Store is engaged in the business of distributing goods to the public. For example, the City Store sells T-shirts and mugs. If a

T-shirt catches fire or a mug breaks, the injured party could sue the City under a construction defect or design defect theory.

Whether or not the City is vulnerable to a products liability suit arising out of the sale of its Diversity Program

by the Centre for Organization Effectiveness will turn on the classification of that program as either a good or a service. A long line of cases -- primarily dealing with the medical profession -- hold that the doctrine does not apply to "persons who sell their services for the guidance of others in their economic, financial, and personal affairs . . . ." Carmichael v. Reitz, 17 Cal. App. 3d 958 (1971). In that case a doctor prescribed a drug which produced side effects in the patient. Although the doctor's services involved the distribution of a drug which is a good, the essence of the transaction was to render professional services and thus the use of products in the course of treatment was merely incidental. Id. at 979. Similarly, in Shepard v. Alexian Brothers Hospital, 33 Cal. App. 3d 606 (1973), contaminated blood transfusions, although a product, did not give rise to a products liability suit against the hospital preforming the transfusion. Characterizing the primary function of a hospital as that of providing services in an endeavor to restore patients's health, the court held that providing medicine or supplying blood was simply an instrument utilized to accomplish the objective of cure or treatment. Id.

While primarily appearing in litigation brought against the medical profession, the goods/services distinction has been extended to characterize other hybrid professions as providers of services. For instance, a travel agency which arranged transportation, accommodation, and meals and presented these arrangements in the form of a "package tour" did not provide a "good," but rather rendered professional services. Pena v. Sita World Travel, Inc., 88 Cal. App. 3d 642, 152 (1978).

Thus, even if the City's Diversity Program is packaged and sold as a "product," it is arguably better characterized as a "service." This is especially true where purchase of the program includes its presentation by a facilitator. And, other than informational literature, it appears that the program does not involve the transfer of any tangible goods. Furthermore, like a hospital, the primary purpose of the program is to treat and hopefully cure an ailment. The ailment sought to cured or alienated by the Diversity Program is various forms of discrimination, and ignorance of cultural diversity in the work environment. For this reason, those who purchase the Diversity Program seek the program's specialized training, experience, skill, and judgment which, because they are services, take the program outside the pale of a products liability suit.

2. Breach of Implied Warranty of Merchantability

The Uniform Commercial Code, with some amendments, was

adopted in California at the 1963 Regular Session of the Legislature and became effective January 1, 1965. In California, the adopted Code is known as the California Uniform Commercial Code. This section deals with the implied warranty of merchantabilityF

Another area of strict liability is the warranty of fitness for the particular purpose. However, this implied warranty arises only when the buyer intends to use the goods for some particular purpose of which the seller is aware, and the buyer relies on the skill and judgment of the seller in choosing the good. Metowski v. Triad Corp., 28 Cal. App. 3d 332 (1972).

in which, like products liability, the defendant is strictly liable for breach. These two actions are in many ways first cousins. The following, however, will make clear their differences, and why the tort action is often more attractive to plaintiffs.

a. Cause of Action

An action of this type can only be brought against someone who is a merchant with respect to the goods sold. Cal. Unif. Comm. Code Section 2314. Services are not defined as a "good" within the provisions of Uniform Commercial Code, Article 2 on sales.

Unlike express warranties which are basically contractual, the impled warranty of merchantability arises by operation of law. Consequently, liability under an implied warranty does not depend on any specific conduct or promise of defendant, but turns on whether the product is merchantable under the Uniform Commercial Code. Hauter v. Zogarts, 14 Cal. 3d 104, 117 (1975).

Originally, the major difference between this breach of warranty action and one for products liability was the requirement of privity in contract. However, when California adopted the Commercial Code it omitted Section 2318 (the privity requirement). By so doing, the two actions were brought even closer, leading some to question whether they had merged into one cause of action. "Pre-emption of strict liability in tort by provisions of Uniform Commercial Code Article 2," 15 American Law Reports, 4th 791. Nonetheless, it is generally accepted that the two remain distinct causes of action.

2. Application to City

The City Store is undoubtedly a merchant and, thus, with any contract for sale there is an implied warranty of merchantability. A loophole exists, however, for the sale of used products. "The general rule has been that a warranty of quality is not implied in a sale of secondhand goods." (55 Cal.

Jur. 3d Sales, Section 81). Thus in Lamb v. Otto, 51 Cal. App. 433 (1921), a case involving the sale of a used automobile, the court held that there existed no implied warranty. The court reasoned that since "┌iσn ordinary sales the buyer has an opportunity of inspecting the article sold, and the seller not being the maker, . . . h┌asσ no special knowledge of the mode in which it was made, . . . the buyer is holden to have purchased entirely on his own judgment." Id. at 436. (Quoting Kellogg Bridge Co. v. Hamilton, 110 U.S. 108, 116 (1884)). Therefore, to the extent that the City Store sells used products, like road signs and parking meters, which are not manufactured by the City, the sale of such products will not give rise to an action for breach of implied warranty of merchantability. To the extent of the City Store sells new goods, the City may be held liable for breach of the implied warranty of merchantability.

Because the Uniform Commercial Code to date does not apply to services, the City's liability regarding the Diversity Program will depend upon the classification of that activity as either a "good" or "service" as discussed in the previous section on products liability.

E. Tort and Civil Rights Liability

1. Tort Liability

Historically, cities, counties and states were largely immune from tort liability because of the common law doctrine of "sovereign" or "governmental" immunity. 5 Witkin Torts Section 105. Over time the immunity has been eroded both by the court and legislatures. In the early 1960's the doctrine of governmental immunity was repudiated by the California courts and shortly thereafter the California legislature replaced it with a comprehensive statutory tort liability and immunity scheme known as the California Tort Claims Act (Government Code Sections 810-996.6) 5 Witkins Torts Sections 127-129.

The general rule governing municipal tort liability today is set forth in Government Code Section 815. It states essentially that a public entity is not liable for its own acts or acts of its employees unless provided by statute. The legislative comment to Section 815 points out that this section abolishes all common law or judicially created forms of tort liability. Some courts interpret this to mean that sovereign immunity still is the rule in California. Cocran v. Herzog Engraving Co., 155 Cal. App. 3d 405, 409 (1984). However, some courts construe the California Tort Claims Act to the contrary and find that its intent was to broaden municipal liability and lessen immunities. See, e.g., Tallmadge v. Los Angeles County, 191 Cal. App. 3d 251 (1987).

The former "governmental" activity vs "proprietary" activity distinction is no longer expressly articulated by the courts to determine tort liability (see, e.g., Ravettino v. City of San Diego, 70 Cal. App. 2d 37 (1945). Many of the statutory immunities still available to cities, however, seem to turn on that distinction. See, for example, failure to enforce laws (Government Code Section 818.2); issuance or denial of permit (Government Code Section 818.4); failure to inspect property (Government Code Section 818.6); to the extent the City enters activities considered propriety in nature, the City may anticipate expanded tort liability.

2. Civil Rights Liability

There are several federal and civil rights statutes on the books, however, the one used most often is 42 USC Section 1983 which states:

> Every person who, under color of any statute, ordinance, regulation, custom, or usage, of any State or Territory or the District of Columbia, subjects, or causes to be subjected, any citizen of the United States or other person within the jurisdiction thereof to the deprivation of any rights, privileges, or immunities secured by the Constitution and laws, shall be liable to the party injured in an action at law, suit in equity, or other proper proceeding for redress. For the purposes of this section, any Act of Congress applicable exclusively to the District of Columbia shall be considered to be a statute of the District of Columbia.

This statute was adopted by Congress in 1871, but was first applied to cities in 1978 to hold them liable for civil rights violations. Monell v. Dept. of Social Services, 436 U.S. 658 (1978). Under this and companion statutes, damages and attorneys fees may be awarded against cities. Depending on the particular entrepreneurship projects, especially the "public/private partnerships," the City may be faced with expanded civil rights liability for acts taken "under color of law," even though they were not conducted by City officials or employees. There are no specific entrepreneurship program fact patterns present for us to analyze yet under this statute. Therefore, we are unable to make

any prediction as to the City's liability in the event of a challenge under 42 USC Section 1983.

CONCLUSION

First, this memorandum analyzes the City's authority to operate various entrepreneurial projects under the state Constitution, state statutes, San Diego City Charter and San Diego Municipal Code. The memorandum goes on to analyze the City's and public officials' liability in the event there is a legal challenge to that authority.

Second, this memorandum explores several potential sources of liability resulting from implementation of various entrepreneurship projects, liability ranging from state and federal taxes, to claims of unfair competition to claims of products liability, to claims for tort and civil rights liability. To the extent possible it attempts to draw conclusions about the likelihood of the City's prevailing in the event a lawsuit is brought under any of these claims.

This memorandum does not find any current entrepreneurship project proposal unlawful. Rather, the memorandum is intended to alert the City Manager to potential serious legal issues that may be raised by particular entrepreneurial projects.

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